

**STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION**

ILLINOIS-AMERICAN WATER COMPANY)	
)	
Proposed general increase in water and sewer)	Docket No. 16-0093
rates.)	

REPLY BRIEF ON EXCEPTIONS OF ILLINOIS-AMERICAN WATER COMPANY

November 4, 2016

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I. INTRODUCTION

Many of the exceptions filed in response to the Proposed Order have no impact on the revenue requirement or rates. For some issues, parties seek language changes for technical reasons. For others, parties do not challenge the resolution of the issue, but want the final order to adopt different reasoning.

Payroll expense, performance pay, purchased power and return on equity (ROE), however, directly affect the revenue requirement. The Proposed Order resolves the payroll expense, purchased power and performance pay issues in a manner that is just and reasonable. The exceptions to the findings on these issues should be rejected.

The only issue where the Proposed Order falls short is ROE. As IAWC explained, an ROE of 8.92 percent would be the lowest ROE ever authorized by this Commission, and would send the wrong message to both the investment community and regulated entities in this state. Such a low ROE would effectively punish IAWC despite undisputed superior management performance, and signal a lack of support for the capital investment required in Illinois. The final order should reflect IAWC's exceptions to ROE.

II. RATE BASE

A. Reply to the AG's Exception 1, "Accumulated Deferred Income Taxes Balance/FIN 48", ALJPO Section II.B.1

The Proposed Order correctly finds that there is no "substantive objection to the Company's modification removing \$2,485,188 from rate base instead of \$3,432,525" to reflect FIN 48 amounts following IAWC's change in its method of account for repairs deductions. (ALJPO at 8.) To confirm that IAWC has in fact changed accounting methods, the Proposed Order directs IAWC to "provide its Form 3115 to the Director of the Commission's Financial Analysis Division as soon as it is available." (ALJPO at 9.)

Form 3115 is now available and has been attached hereto as Attachment A (Confidential and Proprietary). With the change of accounting methods now documented and confirmed, the concerns outlined in the AG's BOE should be satisfied.

III. OPERATING EXPENSES AND REVENUES

A. Reply to Staff's Exception 1, AG's Exception 2, IFC's¹ Exception 2, "Payroll Expense", ALJPO Section III.B.1

The Proposed Order correctly finds that IAWC's estimate of an average of 470 full-time employees in the test year—which is only 4 employees more than IAWC's June 2016 staffing needs and which incorporates 12 anticipated position vacancies—is reasonable. (ALJPO at 30.) Notably, as the Proposed Order acknowledges, the estimated test year headcount is *26 positions less* than the 2013 headcount approved in IAWC's last rate case, resulting in a payroll expense that is \$300,000 less than before. (*Id.*) The Proposed Order, therefore, correctly concludes that any adjustment to IAWC's test year payroll expense should be rejected. (*Id.* at 31.)

On exceptions, Staff, the AG, and IFC dispute this conclusion. (Staff BOE at 3-6; AG BOE at 3-6; IFC BOE at 6-10.) As they did in post-hearing brief, these parties continue to advocate further reducing IAWC's test year headcount to varying degrees, beyond the position vacancies that IAWC has already anticipated, based on no more than IAWC's 2014 and 2015 employee headcounts. But, as the Proposed Order correctly recognizes, there is more to IAWC's workforce than just the number it was before. Even on exceptions, Staff, the AG, and IFC can't get around this. These parties' varying payroll expense adjustments, therefore, remain fatally flawed, in several respects.

¹ Jointly, the Illinois Industrial Water Consumers, the Federal Executive Agencies, and the Citizens Utility Board, sometimes referred to as IIRC/FEA/CUB.

1. Staff, the AG, and IFC still don't explain why it is appropriate to disallow positions that no party disputes are necessary.

Staff's, the AG's, and IFC's proposed vacancy rates would disallow positions that these parties do not dispute are needed to perform work critical to IAWC's core operations. In initial brief, IAWC explained that Staff's 5.40% vacancy rate would disallow 5 planned positions; the AG's 5.77% vacancy rate would disallow 7; and IFC's 7.59% vacancy rate would disallow nearly *all* of the positions that IAWC is recruiting for and plans to fill in 2016. (IAWC Init. Br. at 40 (*citing* IAWC Ex. 2.00SR at 6-7).) Neither Staff, the AG, nor IFC disagreed: in reply brief, no party disputed this fact. (Staff Reply Br. at 22-23; AG Reply Br. at 10-12; IFC Reply Br. at 28-30.)

The Proposed Order again correctly points out that “[n]o party disputed IAWC’s current headcount, or the need for the 24 positions that IAWC seeks to fill.” (ALJPO at 30.) And, although Staff, the AG, and IFC take exception to the Proposed Order’s conclusion regarding payroll expense, again, they do not dispute this particular finding. (*See* Staff BOE at 3-6; AG BOE at 3-6; IFC BOE at 6-10.)

Staff, the AG, and IFC would—without explanation—disallow planned positions that they do not dispute are needed for IAWC’s operations. This alone renders their payroll expense adjustments defective.

2. Staff, the AG, and IFC acknowledge, but fail to comprehend, the context of IAWC’s 2014 and 2015 employee headcounts.

The Proposed Order correctly “finds that the Company’s vacancy estimate is reasonable, due in part to the technological improvements affecting the Company’s workforce since its last rate case.” (ALJPO at 30.) The record evidence shows that after American Water implemented the Business Transformation program in 2013, IAWC’s staff experienced a period of “right-sizing” in 2014 and 2015, as IAWC adjusted to the new information technology systems and

their capabilities. This right-sizing means two things: (1) the 2014 and 2015 headcounts aren't good predictors of future headcounts; and (2) the estimated 2017 headcount already reflects IAWC's technological improvements and so is *26 positions less* than the Docket 11-0767 October 2012-September 2013 test year headcount. (*See* IAWC Init. Br. at 39; IAWC Reply Br. at 26-27; IAWC Ex. 2.00R (2d Rev.) at 6, 8.)

The Proposed Order correctly rejects Staff's, the AG's, and IFC's proposed vacancy rates because they do not account for this right-sizing. (*See, e.g.,* ALJPO at 30 (finding Staff's proposal "does not consider the recent changes the Company has made to staffing due to the Company's technological advancement projects in 2014 and 2015 which impacted the Company's employee headcount.").) In post-hearing brief, Staff, the AG, and IFC did not acknowledge this key context for IAWC's 2014 and 2015 headcounts. (*See, e.g.,* IAWC Reply Br. at 26.) Faced with the Proposed Order's findings, however, for the first time on exceptions, they acknowledge, but misunderstand, that context.

The AG, for example, argues that "[t]he Proposed Order's rationale" in acknowledging IAWC's technological improvements "is upside-down." (AG BOE at 4.) The AG contends that "[t]echnological improvements support a decreasing work force as reflected by IAWC's projected reduced head count [sic] and an increasing vacancy rate, not the reverse." (*Id.*) Yet, as the record evidence shows and the Proposed Order correctly finds, IAWC's technological improvements are both the reason for its 2014 and 2015 vacancy experience *and* its reduced 2017 test year headcount. (IAWC Exs. 2.00 at 10, 16, 19; 2.00R (Rev.) at 6, 8; IAWC Init. Br. at 37-39; ALJPO at 30.) In other words, the vacancies that IAWC experienced in 2014 and 2015 are already reflected in its reduced test year headcount.

Staff seems to recognize this, arguing, "[n]otwithstanding the Company's efforts in this

regard, this reduction is already factored into the Company's current headcount and its projected headcount. These measures will accordingly have no further impact on any vacancy rate the Company can achieve in the future." (Staff BOE at 3-4.) But Staff would nevertheless impute IAWC's 2014 and 2015 vacancy experience to the test year headcount—again. That is inappropriate.

Surprisingly, although Staff, the AG, and IFC now acknowledge (albeit misunderstand) the effect of IAWC's recent technological improvements on its past and future headcounts, they argue that there is "no evidence" that IAWC's test year vacancy rate will be different from its historical vacancy rate. (AG BOE at 3; *see also* Staff BOE at 3; IFC BOE at 4.) That argument, of course, is incorrect. The record evidence regarding implementation of the Business Transformation program in 2013 and the right-sizing that IAWC's staff experienced in 2014 and 2015 *is* that evidence.

3. The AG and IFC's belated proposals to account for overtime expense do not justify their adjustments.

When IAWC cannot fill budgeted positions, current employees must work overtime to complete the attendant work. (IAWC Exs. 2.00R (Rev.) at 4-5; 2.00SR at 3-4; IAWC Init. Br. at 41.) The Proposed Order, therefore, correctly finds that "[c]ertainly, any adjustment to the vacancy rate must account for an offset in the amount of overtime paid to employees." (ALJPO at 30.) The Proposed Order rejects the AG's and IFC's payroll expense adjustments because "neither . . . considered any offsetting overtime expense in its adjustment." (*Id.*)

Initially, the AG and IFC continue to dismiss the excess overtime expense that IAWC incurs when budgeted positions go unfilled, arguing that overtime expense is expected. (*See* AG BOE at 4; IFC BOE at 7.) This is concerning, in light of the impact of *excess* overtime on current employees. (IAWC Ex. 2.00SR at 5; IAWC Reply Br. at 28.) It is better for IAWC to fill planned

full-time positions than for IAWC's current workforce to continue to work overtime. (IAWC Ex. 2.00SR at 5; IAWC Reply Br. at 28.)

Then, however, the AG and IFC attempt to salvage their payroll expense adjustments, by, for the first time, proposing an overtime expense offset to those adjustments. The AG offers that the Commission "could . . . offset the adjustment by a percentage of the test year overtime," and suggests, "[i]n calculating the adjustment, the Commission should use the template provided as Schedule C-2 attached to the AG Initial Brief." (AG BOE at 5.) The AG doesn't provide any calculations, however, with its eleventh-hour proposal.

IFC similarly argue, "if the Commission is convinced that additional overtime is required to offset the proposed reduction in headcount, IAWC has identified an average amount of \$559,444." (IFC BOE at 7.) But, as IAWC explained in post-hearing brief, IFC (and the AG) improperly treat test year payroll expense as a function of the most recent headcount, updating their payroll expense adjustments for IAWC's May 2016 headcount. (IAWC Reply Br. at 28-29; IFC BOE at 4 (advocating a vacancy rate based "on a rolling 12-month average basis since December 2014"); AG BOE at 4-5.) Therefore, for consistency, any overtime expense offset to their adjustments would have to reflect excess overtime expense as of May 2016. That amount is over \$900,000. (IAWC Ex. 2.00SR at 4; IAWC Reply Br. at 29.)

Notwithstanding the AG's and IFC's last ditch embrace of an overtime offset to their payroll expense adjustments, the Commission should reject the adjustments. As IAWC has explained and as the Proposed Order correctly finds, the AG's and IFC's adjustments remain riddled with flaws: they do not consider the context of IAWC's historical headcounts, they would disallow planned positions no party disputes the need for, and they would constrain IAWC's hiring abilities, beyond its June 2016 staffing needs. (IAWC Init. Br. at 38-41; IAWC

Reply Br. at 25-29.)

Staff's position regarding overtime expense on exceptions is, at best, confusing. In post-hearing brief, Staff explained that "Staff further reduced its proposed adjustment to reflect the offsetting effect of additional overtime expense associated with unfilled positions." (Staff Init. Br. at 37.) Accordingly, the Proposed Order correctly notes that Staff's payroll expense adjustment "did consider an offset for overtime." (ALJPO at 30.) On exceptions, Staff continues to advocate a 5.4% vacancy rate, and now a new, alternative 4.3% vacancy rate, but does not mention its prior endorsement of an overtime expense offset. (Staff BOE at 3-4.) (Staff does not propose to alter, however, the Proposed Order's findings regarding overtime expense. (*Id.* at 5-6.)) Staff's overtime expense offset would reduce its 5.4% vacancy rate adjustment to \$143,000. (IAWC Reply Br. at 30; IAWC-Staff Stip. Cross Ex. 1.00 at 18, 20.) Staff has not provided the calculation, but the same offset would presumably completely eliminate Staff's new 4.3% vacancy rate adjustment.

Regardless, as the Proposed Order correctly finds, Staff's adjustment, like the AG's and IFC's, doesn't consider the context of IAWC's historical headcounts. (ALJPO at 30.) Therefore, the Proposed Order correctly rejected Staff's payroll expense adjustment, too.

The Proposed Order correctly finds that IAWC "must have flexibility to hire staff as circumstances demand, to meet service obligations to customers, or deal with unexpected staffing needs. . . . [R]educing the Company's payroll expense may hinder its ability to successfully recruit and hire qualified individuals." (ALJPO at 30, 31.) The Commission should approve this finding. IAWC's workforce is real people, in real employment positions, serving real customers—IAWC's workforce is not just a number.

B. Reply to the AG’s Exception 3, “Annual Performance Plan Expense (Resolved between IAWC and Staff)”, ALJPO Section III.B.2

Fifty percent of IAWC’s Annual Performance Plan encourages employees to improve safety, customer satisfaction, environmental leadership, and operational efficiency with annual compensation that depends on achievement of those operational goals. (ALJPO at 38 (*citing* ICC Staff Ex. 3.0, Attach. G (CP) at 9); IAWC Init. Br. at 45-46.) As the Proposed Order correctly finds, those operational goals benefit ratepayers: “Certainly benchmarks that require reducing OSHA injuries, meeting drinking water quality standards and increasing customer satisfaction survey results directly benefit IAWC’s ratepayers.” (ALJPO at 38.) The Proposed Order, therefore, correctly concludes that the attendant expense should be recoverable in rates. (*Id.* at 37-38.) Staff, IAWC, FEA, CUB, and IAWC all agree. (*See* Staff Init. Br. at 37; IFC Init. Br. (Rev.) at 2; IAWC Reply Br. at 30.)

Only the AG takes exception to this conclusion. The AG continues to advocate wholesale disallowance of IAWC’s Annual Performance Plan expense. (*See generally* AG BOE at 3-6.) On exceptions, however, the AG offers nothing new in support of this extreme position. The AG, instead, continues to make two errors.

First, as it did in post-hearing brief, the AG conspicuously refuses to acknowledge the operational improvements—and consequent customer benefits—that IAWC’s annual performance pay programs have promoted:

OPERATIONAL METRIC	2015	2014	2013
OSHA Recordable Incident Rate	1.24	1.80	2.38
OSHA Days Away/Restricted or Job Transfer Rate	0.62	1.20	1.79
Customer Satisfaction	93%	92%	90%
Service Quality	87%	85%	85%
Commission Complaints	245	502	284
O&M Efficiency Ratio	38.3%	42.0%	44.3%

(*See* IAWC Ex. 2.00R (2d Rev.) at 12-13; IAWC Init. Br. at 45-46. *Cf. generally* AG BOE at 3-6; AG Init. Br. (Rev.) at 22-26; AG Reply Br. at 12-14.) Since, as the AG concedes “[t]he Commission has consistently found that incentive compensation costs related to the achievement of operational goals benefit the utility’s customers [and] are recoverable in rates” (AG BOE at 7), that should end the discussion. The portion of IAWC’s Annual Performance Plan that encourages the above achievements is recoverable in rates.

Second, as it did in post-hearing brief, the AG continues to summarily assert, because there is a financial viability aspect to the Annual Performance Plan, the operational portion of the plan depends on financial goals that primarily benefit shareholders. (AG BOE at 6-7; AG Init. Br. (Rev.) at 23.) That position is short-sighted, and it ignores the plan structure. The AG never explains *why* the financial viability aspect of the plan renders the entire plan—including the portion that indisputably promotes operational achievements—one that primarily benefits shareholders. (*See generally* AG BOE at 6-7.) It doesn’t. (IAWC Reply Br. at 31-43.) Further, the financial viability aspect of the plan requires attainment of an earnings per share level well below even the threshold level necessary to trigger payout under the 50% financial success portion of the plan. This, as the Proposed Order correctly finds, is something different than attaining the earnings per share goal itself; it is meant to ensure that IAWC has the resources to fund the plan. (ALJPO at 38; IAWC Reply Br. at 31-32.) The AG, unlike the Proposed Order, does not understand that “financial viability” does not equal “financial success.”

The Proposed Order correctly concludes that the portion of IAWC’s Annual Performance Plan expense that promotes operational achievements—and consequent customer benefits—is recoverable in rates. Most apt, perhaps, of the Proposed Order’s findings supporting this conclusion is another crucial point the AG overlooks: “the APP payout is a component of market

value employee salaries that would typically be recoverable. As IAWC notes, it currently pays its employees below market value. By disallowing recovery of 100% of employees' incentive compensation, the Company may decide it can no longer offer an APP to its employees, bringing IAWC's employee compensation even lower than its competitors and making it difficult for the Company to attract and retain qualified personnel." (ALJPO at 39.) The Proposed Order correctly rejects the AG's extreme and disproportionate wholesale disallowance of IAWC's Annual Performance Plan expense. The Commission's final order should do the same.

C. Reply to the AG's Exception 4, "Purchased Power Expense", ALJPO Section III.B.3

The Proposed Order correctly finds that the AG's adjustment to IAWC's purchased power expense would not allow IAWC to fully recover its test year purchased power costs. The Proposed Order, therefore, correctly rejects the AG's adjustment. (ALJPO at 40-41.)

In taking exception to this finding, the AG continues to misunderstand IAWC's purchased power expense, ignore the record evidence, and advocate an overstated adjustment. The Commission's final order, therefore, like the Proposed Order, should reject the AG's purchased power expense adjustment.

When it prepared its test year forecast for this case, IAWC adjusted its originally-forecasted 2017 purchased power expense by \$219,035 to reflect two power supply agreements (one each for MISO and PJM supply) that IAWC entered in September 2015. (IAWC Init. Br. at 50; IAWC Exs. 2.00R (2d Rev.) at 15; 4.00 at 13.) Capacity costs account for 15-20% of total retail power costs under the agreements; non-capacity components include Ameren and ComEd distribution rates and fixed costs. (IAWC Init. Br. at 50; IAWC Ex. 2.00R (2d Rev.) at 15; AG Grp. Cross Ex. 1 (Part 3) at 35.) After IAWC filed this case, MISO announced lower capacity costs for its June 1, 2016 through May 31, 2017 planning year. (IAWC Init. Br. at 51; AG Ex.

1.0 at 20-21.)

The AG misunderstands IAWC's \$219,035 pro forma adjustment. Based on the decrease in MISO capacity costs alone, the AG asks the Commission to eliminate the entire adjustment. (AG BOE at 10-12.) This, however, ignores the non-capacity components of IAWC's purchased power costs under the MISO power supply agreements and the PJM agreement entirely. (IAWC Init. Br. at 50-51; IAWC Reply Br. at 35; IAWC Ex. 2.00R (2d Rev.) at 16-17.) On exceptions, the AG states—without record citation—that “[t]his portion [\$219,035] of the pro forma adjustment increased purchased power costs for the *anticipated* results of the MISO capacity auction that occurred in April, 2016.” (AG BOE at 10 (emphasis sic).) But that simply is not accurate: the adjustment reflects the overall impact of the September 2015 agreements, including the results of MISO's 2015 (not 2016) capacity auction. (IAWC Exs. 2.00R (2d Rev.) at 15-16.)

The AG also contends that “[t]he Commission should not assume—as IAWC asks—that MISO's capacity cost will more than double to \$150 per megawatt-day.” (*Id.* at 13.) The AG asks the Commission, instead, to assume that MISO capacity prices (and, presumably, the other components of IAWC's purchased power expense) will remain constant for the last seven months of the 2017 test year. (*Id.* at 11-12.) That, however, ignores the record evidence. The record evidence shows that the components of IAWC's purchased power expense fluctuate—MISO's capacity costs especially: for the 2013/2014 planning year, they were \$1.05/megawatt day; they rose to \$16.75/megawatt day in 2014/2015; rose again, significantly, to \$150/megawatt day in 2015/2016; and then fell to \$72/megawatt day for the 2016/2017 planning year. (IAWC Init. Br. at 51; IAWC Ex. 2.00R (2d Rev.) at 15.) It is unreasonable to assume, therefore, as the AG asks the Commission to do, that MISO's capacity costs will not change in the test year.

Finally, the AG proposes—for the first time on exceptions—that the Commission should

alternatively reduce IAWC's purchased power expense by \$118,161. (AG BOE at 12.) In footnotes, the AG also offers, but claims to not advocate, an alternative \$332,122 adjustment, based not on any record evidence, but on the AG's math in brief. (*Id.* at 11-12, n.22, n.25.)

These after-eleventh hour proposals came in exceptions briefing. So, the Commission should ignore them. *See, e.g., Ill. Comm. Comm'n*, Docket 94-0066, Order, 1995 Ill. PUC LEXIS 176, *266-68 (Feb. 23, 1995) (disregarding proposal offered for the first time in brief, to which no party had the opportunity to respond); *see also* 83 Ill. Admin. Code 200.830(e) ("Statements of fact in briefs on exception and replies to briefs on exception should be supported by citation to the record").

Regardless, the AG's new proposals, like its original adjustment, ignore the record evidence. Accounting for the September 2015 PJM territory contract and the increase in capacity costs in PJM's territory from the 2016/2017 to 2017/2018 planning years, the temporary benefit to IAWC of the reduced capacity cost in MISO's territory for the 2016/2017 planning year, through the first five months of the test year, is approximately \$118,000. (IAWC Ex. 2.00R (Rev.) at 17.) That number, however, does not account for the increase in non-capacity price components of approximately 2% under IAWC's September 2015 power supply contracts, which would offset the temporary \$118,000 benefit. (*Id.* at 16-17.) Therefore, that adjustment, like the AG's \$219,035 adjustment, is overstated.

For these reasons, the Proposed Order got it right. IAWC's forecasted test year purchased power expense, including the pro forma adjustment the Company made to reflect its September 2015 power supply agreements, is a reasonable estimate of IAWC's test year purchase power expense. It will allow IAWC to recover the expense it incurs to power its buildings, pumping stations, and treatment plants, to deliver water and sewer service to customers.

D. Reply to IFC's Exception 3, "Test Year Sales Level", ALJPO Section III.B.4

The Proposed Order rejects IFC's proposed adjustments to the level of residential and commercial sales in the test year. (ALJPO at 44-45.) The Proposed Order correctly found that a regression analysis is the "most appropriate method" to calculate customer usage in the test year, rejecting IFC's argument that test year residential usage should be set equal to average usage over the last five years. (*Id.*) The Proposed Order notes that IFC's five-year average produces a forecast for the 2017 test year that is higher than actual usage in the last several years, despite IFC's acknowledgement that sales are declining annually. (*Id.*)

IFC take exception to these findings on four grounds, each of which should be rejected.

First, IFC argue that sales to commercial customers are stable, and that commercial usage in the test year should be forecasted as equal to usage among commercial customers in 2015. (IFC BOE at 11-12.) In support of its contention that commercial usage is stable, IFC first repeat its witness's statement that IAWC's analysis of commercial usage is "flawed." (*Id.* at 11; *see also* IFC Ex. 2.0 (Rev.) at 5.) As IAWC explained in briefs, IFC's testimony contains no explanation of any purported flaws in IAWC's analysis of commercial usage. (IAWC Init. Br. at 58.) IFC's BOE similarly provides no explanation of any flaw in the Company's analysis. Without this key information, IFC's position is unsupported, and the Proposed Order was correct to reject it.

IFC also provide, in support of its contention that *commercial* usage is stable, a regression analysis of *residential* usage. (*Id.* at 12.) This provides no support for IFC's position, since it concerns the wrong class of customers.

Second, IFC take exception to the Proposed Order's finding that "the parties appear to agree that a regression analysis is the best way to plot large data sets of water usage." (*See* ALJPO at 44; IFC BOE at 13.) IFC state they do not agree regression is the proper tool for

forecasting customer usage in the test year, because “five-year averaging ... is the superior methodology.” (IFC BOE at 13.) This argument does not withstand scrutiny.

Although IFC state that its witness “did not agree that a regression analysis was *the only* or the best way to calculate a trend in data,” (IFC BOE at 13 (emphasis in original)), IFC *never presented any other method* of calculating a trend in data. Rather, throughout the proceeding, IFC relied exclusively on regression analyses to describe the trends in water usage. IFC’s witness agreed that regression analysis is “an appropriate methodology for calculating a trend in data,” presented the results of three regression analyses in his rebuttal testimony, and used these analyses as the basis for all of his conclusions regarding the existing degree or rate of decline in use among IAWC’s customers.² (See IFC BOE at 13; IFC Ex. 2.0 at 4-6, Figures 1, 2, 3.) Thus, despite IFC’s contention that a regression analysis is not the “only” way to calculate a trend in data, regression analysis is the only method they presented.

It is true that IFC chose not to rely upon the results of their regression analyses forecast usage in the test year, but rather used an average of the last five years of usage data. But this merely illustrates that IFC’s proposal to use a five-year average is unsupported. IFC’s argument is that a five-year regression analysis, which shows a *decline* in usage of 1.79% per year, supports the use of an entirely different method (the five-year average), which would set usage in the test year significantly above actual usage in each of the last three years. (IAWC Reply Br. at 37.) The Proposed Order properly found that this “is not reasonable.” (ALJPO at 44).

IFC attempt to support the choice to reject their own regression analyses in favor of a five-year average by arguing that “[i]t cannot be assumed that [efficiency measures] will continue to have exactly the same impact going forward as they have in years past.” (IFC BOE at

² But IFC did not rely on the results of these regression analyses to forecast usage in the test year.

13.) IFC would like the Commission to conclude that efficiency gains will be less in the 2017 test year than over the last ten years. But the record evidence in this proceeding shows that the existing declining trend in usage is likely to extend up to 50 years into the future. (IAWC Ex. 8.00 at 13, 19-20.) Although IFC state that, “[a]t some point, efficiencies from such measures will wear off,” it did not present any evidence as to when that point will occur, much less that it will occur in 2017. (IFC BOE at 13.)

In sum, IFC have shown no reason to alter the Proposed Order’s findings that a five-year average is a less preferable predictor of usage in the test year than the Company’s regression analysis.

Third, IFC critique the Proposed Order’s finding that “the trend line that resulted from [IAWC’s] regression analysis has a 99.[9]5% chance of correctly predicting usage in the test year.” *See* ALJPO at 44; IFC BOE at 14; *see also* IAWC Ex. 8.00R (Rev.) at 12 (stating the 99.95% chance).) The Proposed Order’s finding on this point however, is conceptually correct. IAWC’s regression analysis produced a trend line that illustrates a decline in residential usage of approximately 2.03% per year, in each of the last ten years. (IAWC Ex. 8.00R (Rev.) at 10, Table 8.03.) The trend line has a 99.95% chance of accurately representing the data during the ten-year historical period. (*Id.*) In other words, there is a 0.05% chance that usage declined by an amount *other* than 2.03% in each of the last ten years. (*Id.*) IAWC reasonably forecasted that usage would continue to decline at a rate of 2.03% per year, given the extremely high likelihood that the 2.03% decline occurred in each of the past ten years.

Fourth, IFC take exception to the Proposed Order’s finding that the weather analysis presented by IFC and IAWC’s responsive analysis were both “flawed.” (*See* ALJPO at 45; IFC BOE at 15.) The Proposed Order noted the parties had pointed to various flaws in each other’s

weather analyses, and found that the more reasonable approach was to use “the Company’s initial analysis,” which focused on non-weather-sensitive usage. (ALJPO at 45; IAWC Reply Br. at 38.) IFC do not dispute the Proposed Order’s finding that its analysis was based in part on data regarding 2012, which was abnormally hot and dry. (IFC BOE at 15.) Nor do IFC provide a reason that the Commission should favor its weather-based analysis over IAWC’s analysis of base usage. (*Id.*) The Proposed Order’s findings on this point are reasonable.

IV. CAPITAL STRUCTURE AND RATE OF RETURN

A. Reply to Staff’s Exception 2A, “Cost of Common Equity” – DCF Weighting, ALJPO Section IV.B.1

Staff does not take exception to the recommended ROE, but criticizes the Proposed Order for giving “undue weight to DCF analyses.” (BOE at 7.) The issue observed by Staff is a consequence of the Proposed Order’s decision to exclude most of the ROE analyses presented in the case, and arrive at an ROE by averaging IFC’s DCF, an adjusted version of the Company’s DCF, and Staff’s CAPM. Weighting the DCF and CAPM results in the manner Staff believes they should be weighed (i.e., by averaging the two DCF analyses, and then averaging that result with Staff’s CAPM) would have no practical consequence, since it would yield more or less the same result as the Proposed Order. (*See id.* at 8.) The only reason for this re-weighting exercise is consistency with “the Commission’s past practice.” (*Id.*)

If “the Commission’s past practice” is the touchstone for determining a reasonable ROE, then much of the work performed in this case can be ignored, and the 9.81 percent ROE recently authorized for Aqua can also be adopted for IAWC. While the general principles reflected in prior Commission decisions should be honored (unless there is good reason not to), the Commission has discretion to consider how parties’ recommendations are weighted based on case-specific facts and circumstances. The Commission is not required to give equal weight to DCF and

CAPM results.

With this said, Staff does raise a point that supports resolution of the ROE issue in the manner discussed in the Company's BOE. The Proposed Order does in fact "overweight" the DCF results, which would not be problematic in and of itself, but for the fact that the evidence in this case shows that current market conditions cause the DCF to understate the cost of equity. (IAWC Init. Br. at 5-6; IAWC Ex. 10.00R at 8.) Instead of excluding more parties' results than are included, the final order should strive for inclusion. Each party's final recommendation has been criticized as too high or too low. By averaging these recommendations—and giving the Company's recommendation the weight it is due—the Commission may resolve the ROE issue in a manner that considers not only the evidence of record, but has the added benefit of consistency with past Commission practice. *See, e.g., Aqua Ill. Co.*, Docket 14-0419, Order at 43-44 (March 25, 2015). The weighted average of the recommendations in this case produces a range that, when considered in light of management performance, justifies an ROE of at least 10 percent.

B. Reply to Staff's Exception 2B, "Cost of Common Equity" – Rider VBA Adjustment, ALJPO Section IV.B.1

The Proposed Order approves Rider VBA, but rejects any downward adjustment to the ROE to reflect a difference in risk with the rider versus without it. The Proposed Order properly found that no such adjustment is necessary because ratemaking mechanisms like Rider VBA "are widespread in the utility business and they are already largely embedded in the financial data used to derive the [parties'] ROE estimates." (ALJPO at 67-68.) Neither argument raised by Staff justifies a different conclusion.

Staff first argues that alternative ratemaking mechanisms were *not* included in the data used to derive its ROE estimates; rather, "Staff based its analysis on different sample

[companies], selected to reflect IAWC's current risk *without* Rider VBA.” (Staff BOE at 9 (emphasis in original).) But this is not what Staff stated in testimony. In describing the Water Sample proxy group, Ms. Kight-Garlich made no mention of the presence or absence of alternative ratemaking mechanisms. (See ICC Staff Ex. 5.0 at 3-5.) The presence or absence of alternative ratemaking is not among the twelve factors she considered in selecting proxy companies. (*Id.* at 3.) Indeed, contrary to the notion of excluding proxy companies based on specific ratemaking mechanisms, Staff acknowledges that “many of the Companies in Staff’s samples have mechanisms similar to Rider VBA in place.” (Staff BOE at 10.) Thus, Staff concedes the factual premise relied on by the Proposed Order. Because many of the sample companies already have Rider VBA-like mechanisms, developing an ROE from the financial data of these companies *and* adjusting the final result downward would vastly overstate whatever impact Rider VBA may have.

Even if Staff had selected proxy companies based on the presence or absence of particular rate mechanisms, that is *not* how Staff calculated its eight-basis point adjustment. Staff developed its adjustment by looking at the credit ratings of IAWC’s parent company and basically guessing how Rider VBA would impact IAWC’s risk relative to that of its parent. (See ICC Staff Exs. 5.0 at 36-37; 5.0, Sch. 5.07.) Thus, Staff’s adjustment does not reflect any alleged difference in risk between IAWC and the proxy companies; rather, it reflects only the difference in risk between IAWC and American Water.

Secondarily, Staff argues that the Proposed Order “departs from past Commission decisions on this issue.” (Staff BOE at 11.) Staff cites several cases in which the Commission adjusted ROE downward to reflect a “risk-reducing ratemaking mechanism.” (*Id.*) But the most recent decision cited was issued in 2010. Since that time, the Commission has issued at least

three orders approving alternative ratemaking mechanisms *without* any corresponding adjustments to ROE. *See, e.g., Ameren Ill. Co.*, Docket 15-0142, Order at 109, 89 (Dec. 9, 2015) (approving Rider VBA without any corresponding downward adjustment to ROE); *Aqua Ill. Co.*, Docket 14-0419, Order at 49 (March 25, 2015) (no adjustment to ROE, despite existence of QIP); *North Shore Gas Co., et al.*, Dockets 11-0280/0281 (cons.), Order at 140 (Jan. 10, 2012) (permanently approving Rider VBA with no adjustment to ROE). The most recent Commission cases reflect the fact that the growing prevalence of alternative ratemaking mechanisms makes express downward adjustments to the ROE unnecessary.

The Proposed Order logically and appropriately rejects the argument that approval of Rider VBA should result in a downward adjustment to ROE. This conclusion should be reflected in the final order.

V. RATE DESIGN AND COST OF SERVICE

A. Reply to IWC/FEA Exception 1, “Purchased Power Cost Allocation”, ALJPO Section VI.B.1

The Proposed Order rejects IWC/FEA’s proposal to alter the allocation of purchased power costs. (ALJPO at 79-80.) The Proposed Order correctly finds that IWC/FEA’s preferred allocation factor—Factor 6— “does not accurately account for the base and extra capacity components of the Company’s electric demand costs,” while the Company’s proposed allocation factor—Factor 1—“reflects the cost of service,” is “based on the AWWA Manual’s procedures which are commonly used in COSSs and rate design,” and “was previously approved in IAWC’s last rate case.” (*Id.* at 80.) IWC/FEA take exception to these conclusions on two grounds, both of which were addressed in IWC/FEA’s briefs. IAWC has shown that neither of these grounds withstands scrutiny.

First, IWC/FEA argue that Factor 6 is appropriate because it “recognize[s] both the base

and extra capacity class components of purchased power expense.” (IIWC/FEA BOE at 2.) As explained in IAWC’s initial brief, 1.25% of IAWC’s purchased power costs is attributable to extra demand. (IAWC Init. Br. at 81.) If IIWC/FEA’s proposal to utilize Factor 6 was adopted, 42.6% of power costs would be allocated to extra demand. (*Id.*) Thus, the Proposed Order correctly found that Factor 6 clearly does not accurately account for the base and extra capacity components of IAWC’s purchased power costs. (ALJPO at 80.)

Second, IIWC/FEA argue that “[u]se of Factor 1 ignores the effect that class contributions to peak demand have on purchase [sic] power costs.” (IIWC/FEA BOE at 3.) As IAWC discussed in its reply brief, there is no record evidence regarding any differences in classes’ contributions to peak power demand, because IIWC/FEA discussed this topic for the first time in its initial brief. (IAWC Reply Br. at 44-45.) The Proposed Order correctly found that there was “no evidence in the record” to support IIWC/FEA’s argument on this point. And on exceptions, IIWC/FEA cannot cite to any record evidence.

Instead, IIWC/FEA offer the explanation that, “[i]n its Briefs, IIWC/FEA expanded an argument already put forth” on the subject. (IIWC/FEA BOE at 3.) This misstates the record. IIWC/FEA’s witness never testified that classes contribute differently to peak power demand, much less quantified “the effect” of any such differences. Its briefing did not “expand an argument already put forth,” but advanced an entirely new argument. The Commission must base its findings on record evidence. Briefing is not record evidence, and no matter how many times IIWC/FEA make this argument in briefs, they cannot cure its failure to present evidence on this point. The Proposed Order correctly found that there is “no evidence to support IIWC/FEA’s argument ... regarding the variations among classes’ contributions” to peak demand. (ALJPO at 80.)

B. Reply to IWC/FEA's Exception 2, "Simplification of Metered Large User Water Tariff", ALJPO Section VI.B.2

The Proposed Order rejects IWC/FEA's proposal to alter IAWC's Metered Large User Water Service tariff, finding that the proposal was not "sufficiently detailed" because IWC/FEA did not "specify which portion of the existing formula IWC/FEA seek to eliminate or any specific descriptions or calculations of the recommended rate design." (ALJPO at 82.) The Proposed Order found, in contrast, that the formula in the tariff "serves important purposes and provides appropriate incentives." (*Id.*) Specifically, the Proposed Order notes that the current tariff utilizes the maximum day demand ratio³ to determine rates, and finds that this incentivizes the very large water users taking service under the tariff to "smooth their demand in a way that minimizes the need for costly extra capacity and peak facilities." (*Id.*)

On exceptions, IWC/FEA argue that the important purpose of minimizing the need for investment in costly facilities should be outweighed by the fact that additional customers might consider taking service under the tariff, if charges under the tariff were not based on maximum day demand. (IWC/FEA BOE at 5-6.) This argument is problematic for several reasons.

First, IWC/FEA state that, "if a large customer fails to monitor or sufficiently manage its maximum demand *the Company* can change the customers' rate by making changes to the maximum day ratio between rate cases." (*Id.* (emphasis added).) The Company cannot change the formula in the tariff—which multiplies the customer's maximum day demand ratio by approximately \$0.19—without approval from the Commission. 220 ILCS 5/9-201(a); (*see also* ILL. C.C. No. 24, Sec. 1 Eighth Rev. Sheet 14.1.) Thus, the only way the rate charged to a customer can change between rate cases is if the customer's maximum demand ratio changes. It

³ The maximum day demand ratio is the customer's maximum day demand divided by the customer's average day demand. (ILL. C. C. No. 2, Sec. 1, Eight Rev. Sheet 14.1.)

is not the Company that is changing the rate charged to the customer—it is the customer.

Second, IWC/FEA's argument is based on their statement that "if a large customer fails to monitor or sufficiently manage its maximum day demand," its rates will increase. (IWC/FEA BOE at 5-6.) But this is precisely the purpose of the tariff, and the incentive the tariff is designed to create. As the Proposed Order noted, when a customer's maximum day demand is closer to their average day demand, it minimizes the need for costly facilities. And as the Proposed Order found, this is an "important purpose" and an "appropriate incentive." (ALJPO at 82.) It would not be appropriate for the Commission to do away with the incentive for the Company's largest users to manage their maximum demand.

Finally, IWC/FEA take exception to the Proposed Order's conclusion that their proposal was not sufficiently detailed. (IWC/FEA BOE at 5.) IWC/FEA state their proposal is "extremely simple and such simplicity should not be considered a lack of detail." (*Id.*) Yet, when IAWC requested that IWC/FEA provide an explanation or calculation of its proposed simplification in discovery, IWC/FEA witness Collins responded that he had not "recommended a specific rate design, but proposes that a specific cost-based rate design be developed cooperatively." (*See* IAWC Ex. 11.00R at 8.) So IWC/FEA have not actually put forth a proposal. IWC/FEA acknowledge as much when they argue the Commission should order a workshop so that "interested parties [can] work through the details" of the revised tariff. (*Id.* at 6.) There is no revised tariff for the Commission to approve in this case, and IWC/FEA have not supported their request for a workshop. The Proposed Order properly rejected IWC/FEA's proposal to require a workshop.

C. Reply to IWC/FEA's Exception 3, "Limitation of Increase by Class", ALJPO Section VI.B.5

The Company does not object to IWC/FEA's proposed clarification that the class increases should be adjusted for the Company's final revenue requirement. (*See* IWC/FEA BOE at 9.)

D. Reply to IWC/FEA's Exception 4, "Demand Factors", ALJPO Section VI.B.6

In Docket 09-0319, the Commission directed IAWC to perform a direct measurement demand study, in which IAWC measured and analyzed actual hourly consumption for a sample of customers in order to determine demand factors. (IAWC Exs. 11.00 (Rev.) at 10; 11.02 at 12.) That study, which began in May 2011, produced one season of data that formed the basis for the demand factors approved in Docket 11-0767. *Ill.-Am. Water Co.*, Docket 11-0767, Order at 113-14 (Sept. 19, 2012).

The direct measurement demand study has been ongoing since May 2011, and now reflects five years of actual usage data. That more recent and comprehensive data set formed the basis for IAWC's demand factors in this case. (IAWC Ex 11.02.) The Proposed Order thus correctly found that IAWC's proposed demand factors "reflect the most recent and comprehensive available data concerning its customers' demand" and properly rejects IWC/FEA's proposal to revert to the demand factors approved in its last rate case. (ALJPO at 91.) Every other party that offered testimony on this subject agreed that the results of IAWC's demand study are valid and will remain valid for ten years. (IAWC Init. Br. at 49-50.)

On exceptions, IWC/FEA "does not dispute that the proposed demand factors reflect the most recent available actual data regarding IAWC customers' demand," but "dispute[s] the validity" of this data, arguing that the "significant disparity" between the demand factors approved in IAWC's last rate case and its proposed demand factors in this case "has not been

thoroughly explained.” (IIRC/FEA BOE at 11.) IIRC/FEA argue IAWC should be required to continue its direct measurement study, even though it is costly. (*Id.*)

IIRC/FEA do not claim that IAWC has failed to comply with the Commission requirement to perform a direct demand study, nor do IIRC/FEA claim that the direct measurement demand data in this case is in any way inaccurate. IIRC/FEA also do not explain how demand factors produced by direct measurement of actual customer usage could be “invalid.” Instead, IIRC/FEA’s concern appears to simply be that the demand factors are different from Docket 11-0767. But it is no surprise that the demand factors in this case are different: as IAWC has explained throughout this proceeding, and as the Proposed Order found, the demand data in this case are based on five years of monitoring instead of one season, and so are the most recent, most comprehensive data available about IAWC’s customers’ actual usage. (IAWC Reply Br. at 49; IAWC Init. Br. at 87; IAWC Ex. 11.00R at 3.) Most importantly, the demand study data in this case reflects a system peak in 2012, which the data in Docket 11-0767 did not. (IAWC Ex. 3.00 at 32.) Thus, the demand data in this case produce demand factors that are more representative than those in the prior case.

IIRC/FEA also argue that IAWC should be ordered to continue the direct demand study, despite its cost, in order to “assist with the determination of demand factors in the next rate case.” (IIRC/FEA BOE at 12.) This argument ignores the Proposed Order’s finding that IAWC will submit evidence in future rate cases that there has not been a significant change in the ratio of peak to average demand, and submit a direct demand study once every ten years. (ALJPO at 91.) This requirement will assist in the Commission’s evaluation of demand factors in future rate cases. This argument also ignores the fact that every other party that offered testimony on this subject—Staff, the AG, and IAWC—agreed that it is not cost-effective to continue the demand

study. (IAWC Init. Br. at 49-50.)

VI. CONCLUSION

For the reasons discussed above, IAWC submits that the Exceptions addressed above should be rejected. For the reasons stated in IAWC's Brief on Exceptions, the Company requests the Commission adopt the Exceptions set forth in IAWC's Brief on Exceptions.

Dated: November 4, 2016

Respectfully submitted,

ILLINOIS-AMERICAN WATER COMPANY,

By: /s/ Albert D. Sturtevant

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CERTIFICATE OF SERVICE

I, Albert D. Sturtevant, an attorney, certify that on November 4, 2016, I caused a copy of the foregoing *Reply Brief on Exceptions of Illinois-American Water Company* to be served by electronic mail to the individuals on the Commission's Service List for Docket 16-0093.

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